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FILED
MAR 13 1947

No. 998

In the Supreme Court of the United States

OCTOBER TERM, 1946

ST. REGIS PAPER COMPANY, PETITIONER

v.

JOSEPH T. HIGGINS, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the District Court (R. 84–108) is unreported. The opinion of the Circuit Court of Appeals (R. 132–135) is reported at 157 F. 2d 884.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered November 8, 1946. (R. 136.) Petition for writ of certiorari was filed February 8, 1947. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the dividends received by the taxpayer during the calendar years 1936 and 1937 were income to the taxpayer in those years within the meaning of Section 22 (a) of the Revenue Act of 1936, although refunded to the declaring corporation in 1938 because their declaration was an alleged breach of a trust indenture.

STATUTE INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived * * * from interest, rent, dividends * * *

STATEMENT

St. Regis Paper Company, hereinafter called the taxpayer, was the sole stockholder of Bates Valve Bag Corporation, a New Jersey corporation, hereinafter called Bates. In December, 1936, taxpayer received $150,000 and in December, 1937, $115,000 as cash dividends from Bates. (R. 86.)

During the year 1938 the trustee for debenture holders under an existing indenture dated August, 1927, with a predecessor corporation wrote to Bates claiming that the declaration and payment of the two cash dividends was in violation of Section 13 of Article Four of the indenture. (R. 70–71, 79, 86.) On December 14, 1938, the direc-

tors of Bates rescinded the resolution declaring the respective dividends and by a check dated December 15, 1938, in the sum of $265,000 taxpayer refunded the full amount of the dividends received in December, 1936, and December, 1937. (R. 81–82, 87.)

Meanwhile, taxpayer had reported the dividends as income, in its income tax returns filed for the calendar years 1936 and 1937. In accordance with Section 14 of the Revenue Act of 1936, the dividends received became part of the adjusted net income upon which a surtax on undistributed profits for the respective tax years was paid to the Collector. (R. 87.)

After the dividends were refunded to Bates, the taxpayer on January 12, 1939, filed with the Collector claims for the refund of that part of the surtax on undistributed profits which was attributable to the inclusion of the dividends as income. (R. 16.) The claim for refund for the calendar year 1936 having been rejected by the Commissioner of Internal Revenue and the claim for refund for the calendar year 1937 not having been finally acted upon by the Commissioner within six months after it had been filed, this action was instituted by the filing of a complaint on February 25, 1941. (R. 87–88.) The complaint was dismissed after a trial without a jury by the District Court. (R. 125.) The Circuit Court of Appeals affirmed. (R. 132–135.)

ARGUMENT

In 1936 and 1937 the taxpayer received dividends in cash from its wholly owned subsidiary which the taxpayer repaid in 1938 because their declaration allegedly violated a trust indenture. Both the district court and the circuit court of appeals held that the taxpayer received the dividends under "claim of right" and that accordingly they constituted income in the year received. The claim-of-right principle was adopted by this Court in *North American Oil* v. *Burnet*, 286 U. S. 417, and has been applied in a long line of decisions holding amounts taxable in the year received or accrued without regard to whether they must later be repaid. *Fleischer* v. *Commissioner* (C. C. A. 8), decided December 5, 1946 (1947 C. C. H., par. 9102); *Caldwell* v. *Commissioner*, 135 F. 2d 488 (C. C. A. 5); *Moore* v. *Thomas*, 131 F. 2d 611 (C. C. A. 5); *Penn* v. *Robertson*, 115 F. 2d 167 (C. C. A. 4); *First Nat. Bank* v. *Commissioner*, 107 F. 2d 141 (C. C. A. 6); *Saunders* v. *Commissioner*, 101 F. 2d 407 (C. C. A. 10); *Griffin* v. *Smith*, 101 F. 2d 348 (C. C. A. 7), certiorari denied, 308 U. S. 561; *National City Bank of New York* v. *Helvering*, 98 F. 2d 93 (C. C. A. 2); *Barker* v. *Magruder*, 95 F. 2d 122 (App. D. C.); *Ford* v. *Commissioner*, 51 F. 2d 206 (C. C. A. 6), certiorari denied, 284 U. S. 666; *Board v. Commissioner*, 51 F. 2d 73 (C. C. A. 6), certiorari denied, 284 U. S. 658; *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. 2d 990 (C. C. A. 7), certiorari

denied, 284 U. S. 618; *Schramm* v. *United States,* 36 F. Supp. 1021 (C. Cls.); *McDuffie* v. *United States,* 19 F. Supp. 239 (C. Cls.); *Duffy* v. *Commissioner,* 2 T. C. 568; cf. *Brown* v. *Helvering,* 291 U. S. 193.

The conclusion that the taxpayer received these dividends under claim of right as that term is used in the cited cases is hardly open to question. They were received openly and treated in all respects by the taxpayer as its property. Since as the circuit court of appeals correctly stated the declaration was at most a breach of contract which violated no law and the taxpayer was manifestly not without all semblance of right and title to the dividends (R. 134), the case is unlike *Commissioner* v. *Wilcox,* 327 U. S. 404, with which the petition alleges a "probable" conflict (Pet. pp. 8–9). Not only did the taxpayer claim the dividends as of right but it may be that its right to the dividends was actually absolute. The circuit court of appeals assumed for the purposes of the decision that the taxpayer could have been compelled to return the dividends but stated that this was not clear. (R. 134.)[1]

[1] In view of the provisions of Section 2 (a) of Article Seven of the August 1, 1927, trust indenture (Appendix, *infra*) limiting the remedy for violation of the indenture to a declaration that the principal and interest of all outstanding debentures is immediately due and payable and since in any event under Article Eight (Appendix, *infra*) there can be no recourse for violation against a stockholder, which the taxpayer was here, it seems probable that the repayment was entirely voluntary.

The decision below, contrary to the assertion in the petition, conflicts neither with the decision of the Sixth Circuit in *Knight Newspapers* v. *Commissioner,* 143 F. 2d 1007, nor those of the Court of Claims in *Wells* v. *United States,* 64 F. Supp. 476, and *Greenwald* v. *United States,* 57 F. Supp. 569 (pp. 5–8, 9–10).

The court in the *Knight* case recognized the validity of the claim-of-right principle, cited in the cases applying it, and referred to them as the "clear weight of authority" (pp. 1009–1010). It decided that the doctrine did not apply because that case involved a personal holding company surtax (p. 1010), and because of the fact, which it repeatedly emphasized, that in all the decided cases the taxpayer actually received the money taxed whereas Knight Newspapers received only a credit on the declarant's books, with respect to which no claim of right was ever asserted (pp. 1008, 1010, 1011, 1012). Although we doubt the soundness of these distinctions, the acceptance of them by the Sixth Circuit, with, however, a continued recognition of the validity of the claim-of-right principle, establishes the absence of even a technical conflict with the decision below holding the principle applicable in a different factual situation.

The Court of Claims in both *Wells* v. *United States, supra,* and *Greenwald* v. *United States, supra,* also expressly recognized the vitality of the claim-of-right principle and gave no indication

that it had repudiated its earlier decisions in *Schramm* v. *United States, supra,* and *McDuffie* v. *United States, supra.* There is no conflict with the *Wells* case because the court there found that the payment received by the taxpayer and later refunded was made and received merely as an advance subject to repayment in whole or in part, and not as compensation. The payment was therefore a loan and the claim-of-right principle was not applicable. In the *Greenwald* case the bonuses received by the taxpayer were returned when it was discovered they were based on a fraudulent overstatement of profits by a firm of certified public accountants. The Court of Claims held that the claim-of-right doctrine did not apply since the money was received under a mutual "mistake of fact."

In the instant case, however, the court below concluded that something more than a mutual mistake of fact was involved. Thus, the court below held (R. 134) that, even though it be assumed that the taxpayer's claim of right to receive the dividends was a mistaken one, its claim was not entirely baseless, nor, so far as appears, due to any ignorance of the indenture provisions, and that had the taxpayer persisted in it after the indenture trustee's protest in 1938, substantial questions of law would have had to be resolved in construing all the relevant provisions of the original indenture and the subsequent agreements before repayment by the taxpayer would have

been enforced, if at all. While we believe that the *Greenwald* decision is erroneous, it is a decision that does not repudiate the claim-of-right doctrine which has been applied by the Court of Claims in other cases, and accordingly that decision should be deemed to be restricted to its own peculiar facts.

The decision below is plainly right. As an application of the claim-of-right principle it is supported by a long line of decisions the roots of which are in decisions of this Court. The principle moreover is valid and is basic to the income tax law since it is based on the annual accounting year concept (see *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359), and as most of the decisions applying it state, on administrative convenience, if not necessity, as well. Since no court denies its validity and since this Court in *Commissioner* v. *Wilcox, supra,* has recently had occasion to mark the bounds of its applicability, no uncertainty should arise because of it in the administration of the revenue laws.

Even if a technical conflict exists the petition should be denied because the disagreement exists only in the application of the rule and not in the rule itself. Moreover, in this case since doubt remains as to the legal necessity for the repayment of the dividends the case may be decided against the taxpayer without reaching the claim-of-right contention.

CONCLUSION

There is no substantial conflict of decisions and the decision of the court below is correct. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Acting Assistant Attorney General.

LEE A. JACKSON,

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Special Assistants to the Attorney General.

MARCH, 1947.

APPENDIX

Indenture of August 1, 1927, Exhibit 7: [2]

ARTICLE SEVEN

Remedies in Case of Default

Section 2. In case any one or more of the following events, herein called events of default, shall happen:

(d) Default in the performance or observance of any other covenants, condition or agreement on the part of the Company in the Debentures or in this Indenture contained, and such default shall continue unremedied for a period of ninety days after written notice thereof shall have been given to the Company by the Trustee which may give such notice in its discretion, and shall do so upon the written request of the holders of twenty-five per cent. (25%) in principal amount of the Debentures then outstanding;

then, in each or any such case, the Trustee by written notice to the Company may, and upon the written request of the holders of twenty-five per cent. (25%) in principal amount of the Debentures then outstanding shall, declare the principal of and interest

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[2] By stipulation of the parties in the circuit court of appeals, the trust indenture which is contained in Exhibit 7 (R. 128–129) is not part of the printed record but is before the Court in physical form.

on all the Debentures then outstanding (if not then due and payable) to be immediately due and payable, and, upon such declaration, the same shall become and be immediately due and payable, anything in this Indenture or in the Debentures contained to the contrary notwithstanding; *provided,* that if at any time, either before or after the principal of the Debentures shall have become so due and payable pursuant to declaration by the Trustee, all arrears of interest upon all the Debentures, with interest on overdue instalments of interest at the rate of six per cent. (6%) per annum, all sinking fund arrears and the reasonable charges and expenses of the Trustee, the Agent, and their respective agents, attorneys and counsel, shall have been paid by or on behalf of the Company, and any and every other default known to the Trustee, by reason of which the principal of the Debentures may or might have been declared due hereunder (regardless of any period of time during which such default shall have continued) shall have been remedied and made good to the satisfaction of the Trustee, then, in each such case, the holders of a majority in principal amount of the Debentures then outstanding, by written notice to the Company and to the Trustee, may waive all defaults so remedied and made good and their consequences and rescind any such declaration, and such waiver and rescission shall be binding on the holders of all of the Debentures outstanding, but no such waiver or rescission shall extend to or affect any subsequent default or impair any right consequent thereon.

ARTICLE EIGHT

Immunity of Incorporators, Stockholders, Directors and Officers

No recourse shall be had for the payment of the principal of or interest on any Debenture or of any part thereof or for any claim based thereon or otherwise in any manner in respect thereof, or in respect of this Indenture, to or against any incorporator, stockholder, officer or director, past, present or future, of the Company or of any predecessor or successor corporation, either directly or through the Company or such predecessor or successor corporation, whether by virtue of any constitution or statute or rule of law, or by the enforcement of any assessment or penalty, or in any manner, all such liability being expressly waived and released by the acceptance of any such Debenture and as part of the consideration for the issue thereof.

U. S. GOVERNMENT PRINTING OFFICE: 1947